1992 Federal Budget: a commentary

Background Paper

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THE 1992 FEDERAL BUDGET: A COMMENTARY

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THE 1992 FEDERAL BUDGET: A COMMENTARY

On 25 February 1992, the Minister of Finance, the Hon. Don Mazankowski tabled his first budget in the House of Commons. This budget, like that tabled in 1991, has been subject to the criticism that it is not sufficiently stimulative to help move the economy out of the current recession. Unlike the 1991 budget, however, this budget is tabled in an environment with realistic prospects for steady economic recovery and in which inflation and interest rates are at historically low levels. Both budgets presented some major spending control initiatives. Unlike the last federal budget, this year's provides some modest tax relief as well as some fairly substantial restructuring of the tax system.

NEW FISCAL INITIATIVES

Although the federal government has chosen not to attempt any grand fiscal policy initiatives, it has made major changes to both sides of its fiscal policy ledger: the tax system is to be modified sufficiently to constitute what might be deemed a "mini tax reform" while, on the spending side, major new restraints have been put in place. On balance however, these measures have only a slight direct impact on the net fiscal position of the government.

A. The Revenue Side

On the personal income tax (PIT) side, the budget measures will inject about $1,000 million back to taxpayers in 1992-93 and almost $1,700 million in 1993-94. Over five years, these personal income tax measures should amount to about $7,500 million in direct federal revenue losses.

The greatest PIT revenue loss will result from the eventual two percentage point reduction in the PIT surcharge, which is now set at 5% of basic federal tax. Students and the disabled will also benefit from enhanced tax benefits and there will be a more generous child care expense deduction. Common-law couples are to be treated more like married couples and consequently will lose some of their tax advantages, thus netting the federal government almost $1,000 million over five years.

The most significant change, though, is the proposed restructuring of the child benefits system. The family allowance, income tax credit for dependent children and refundable Child Tax Credit are to be consolidated into one income-related program. The proposed child tax benefit will have characteristics similar to the current refundable Child Tax Credit, although it also borrows a feature from the GST credit whereby maximum benefits are not earned at the lowest income levels. Families with no earned income would receive lower benefits than those with $10,000 in earned income. This feature is intended to benefit low-income working families.

Every family will be eligible for $1,020 for each of the first two children, an additional $75 for the third and every subsequent child, plus a $500 earned-income supplement. An additional $213 per child under the age of seven years will be available where no child care expenses are claimed. The total value of these benefits is to be subject to a 5% reduction beyond a family income threshold. Further details are to be presented in a government White Paper.

It should be noted at this point that the new program is to replace some existing programs that were recorded in the government accounts as tax expenditures and also the family allowance program, which constituted a spending program. The federal government has introduced legislation in Parliament to control program spending and has set limits with which it must comply. The new child tax benefits system is likely to be treated like the present refundable Child Tax Credit, as a tax expenditure rather than a spending program; consequently, the government will have to adjust its program spending limits to conform with the intent of its

legislation and announced in the budget that it would make the necessary amendments to legislation in the future.

While this restructuring does not have a major impact on the government's fiscal position (it costs the government only $2,000 million in lost revenues over five years), it dramatically alters the distribution of benefits among families. Middle-income families gain the most from the reform, particularly single parents in the middle-income group. The relative advantage previously given to two-income families will disappear. One of the major advantages offered to two-income families under the old system was that family allowance payments were made subject to the social benefits reduction tax, which applied only to the higher income earner; this explains why a two-child, two-earner family with $75,000 in total income received almost $500 more in benefits than a one-income family in the same circumstances.

This restructuring clearly eliminates the concept of universality as it relates to child benefits. In fact, with the advent of the social benefits reduction tax, the family allowance had already ceased to be universal in effect, although it continued to be universal in its delivery.

Another less noticed effect is the total repudiation of the concept of horizontal equity in the tax system as it applies to families with children. A high-income taxpayer with children is treated in the same way as one with the same income but no dependent children. It has long been a principle of public finance that taxation be based on economic circumstances and that money income is not necessarily a good gauge of those circumstances. The proposed child tax benefits are designed so as to further satisfy calls for greater vertical equity, yet they do so at the expense of horizontal equity at higher income levels.

The budget does increase the maximum child care expense deduction by $1,000, but this benefit is limited to single parents or two-earner families.

Another widely anticipated feature of this budget allows taxpayers to use up to $20,000 of existing RRSP funds for a down payment on a newly-purchased home. This is to be accomplished by permitting taxpayers

to borrow from existing RRSP accounts and requiring them to repay this amount in full over a 15-year period. Taxpayers have only one year to take advantage of this measure and if they do so, they may not make an RRSP contribution for that year. Thus Canadians cannot increase their RRSP assets in anticipation of purchasing a home. This restriction which ensures that the fiscal impact on the federal budget will remain small.

In addition to the changes noted above, the budget proposes alterations in the field of retirement savings: the previously slated increases in pension and RRSP contribution limits have been set back by one year, and RRIF funds no longer need to be closed out by age 90. The budget proposes that such payments can continue for the life of the retiree. The RRIF rule changes are expected to have a negligible impact on federal finances while the delay in pension and RRSP contribution limits should save the government about $320 million over five years.

The budget also proposes certain tax changes which the government describes as measures to enhance competitiveness. On balance, these will have a small impact on the net fiscal position of the government, reducing revenues by $2,000 million over five years. These measures are largely directed to the manufacturing sector via increased capital cost allowances for manufacturing and processing equipment and a two percentage point reduction in the rate of tax on manufacturing profits. Other measures include restrictions on the capital gains exemption, which would deny such favourable tax treatment for investments in non-principal residence real estate, and a reduction in the rate of tax witholding on direct dividends from 10% to 5% by a means of reciprocal tax treaties with other nations.

For these measures to have an impact on investment, the business community must view them as permanent or at least long-lived. In this regard, however, it should be noted that these measures simply reverse some previous initiatives to increase the effective rate of tax on the manufacturing sector. The 1987 federal tax reform was designed to increase the effective tax rate on manufacturing sector by just over 4%. Earlier budget measures limited the ability of firms to make use of capital cost allowances. If the business community believes that these measures could

again be made less valuable, their beneficial results could be further tempered. More importantly, though, these measures are contrary to the stated goals of past tax reform since the tax system is to be used to favour manufacturing over other corporate activity. A major justification for the 1987 reforms was to stop just such a use of the tax system to direct investment and to allow the market to perform that function.

The combination of tax-related measures is expected to reduce federal revenues by $9,580 million over five years.

B. The Spending Side

To recoup part of the revenues lost as a result of the programs described above, the government has announced an extension of the expenditure control plan of the two previous budgets. These new measures are to save the government $7,300 million over five years.

Thirty per cent of spending reductions are to come from the defence envelope. This is to be accomplished by speeding up the pull-out of Canadian troops from European bases and by reducing new capital spending. Canada Mortgage and Housing spending is to be limited to a 3% annual growth from 1992-93 to 1996-97. Green Plan spending is to be delayed; this will affect spending in fiscal years 1992 and 1993 but will have no impact beyond the five-year horizon.

The bulk of expenditure restraint is to come from what are labelled as management initiatives, amounting to just over 50% of the $7,288 million in savings over five years. Non-wage operating budgets, which last year were frozen, are now to be cut by 3% from planned levels for each of the next five years. In addition, communications spending is to be cut by another $75 million per year and further spending cuts beyond the 3% reduction are slated for Agriculture Canada and Public Works Canada. As part of this restraint package, first class air travel is to be prohibited for parliamentarians and the public service. Cabinet Ministers, including the Prime Minister, will see a 5% reduction in their ministerial pay.

A reduction in grants and contributions is to contribute to spending restraint in the amount of $376 million over five years. Government streamlining is expected to save almost $100 million over the

same period. Although a large number of agencies will be affected by this decision, the total impact on spending will be relatively small. The more notable agencies to be wound up include the Economic Council of Canada, the Science Council of Canada and the Law Reform Commission. Some agencies are being consolidated with government departments, others which have been slated to start up are being deferred and still others, including the Royal Canadian Mint, are being examined for possible privatization.

Tax compliance and cost recovery measures are expected to be worth about $1,600 million and $216 million respectively over five years. It is not obvious why these items, particularly the tax compliance measures, are listed as expenditure control measures when in fact they constitute means by which revenues will be enhanced. While it is true that the tax compliance measures do not represent an increase in tax rates or an increase in the base upon which taxes are applied, they do represent increases in tax collections.

THE FISCAL POSITION AND THE EFFECTS OF THE RECESSION

Although the recent recession was no secret when the 1991 federal budget was presented, it is apparent that the Department of Finance underestimated its impact on the government's fiscal position. The recession is primarily responsible for the trend to a $5,400 million increase in the status quo deficit for 1991-92 and a further $9,900 million increase in 1992-93. It is only because of offsetting policy changes amounting to $5,400 million over two years and unexpectedly lower debt charges of $5,500 million over two years that increase in net public debt will be limited to $4,400 million at the end of 1992-93.

The most evident impact of the recession is on income tax revenues, both at the personal and corporate levels. In total, these reductions amount to $12,600 million over two years and are likely to continue into the future.

Table 1 looks at the federal fiscal position to 1995-96, as predicted by this budget as well as that of the previous year. All of the entries from the 1992 budget are inclusive of whatever policy initiatives have been taken in this budget, i.e. they are not status quo projections.

TABLE 1

REVISED FISCAL PROJECTIONS
(in million dollars)

BUDGETARY ITEM: BUDGET FORECAST	1991-92	1992-93	1993-94	1994-95	1995-96
REVENUE 91	128,500	139,600	150,500	160,300	167,500
REVENUE 92	124,100	132,100	138,800	151,200	161,300
PROGRAM SPENDING 91	115,800	119,650	122,800	126,450	130,600
PROGRAM SPENDING 92	114,000	119,400	119,850	124,100	128,050
OPERATING BALANCE 91	12,700	19,950	27,700	33,850	36,900
OPERATING BALANCE 92	10,100	12,700	18,950	27,100	33,250
DEBT CHARGES 91	43,200	43,950	44,300	43,850	43,400
DEBT CHARGES 92	41,500	40,200	41,450	41,600	41,750
DEFICIT 91	30,500	24,000	16,600	10,000	6,500
DEFICIT 92	31,400	27,500	22,500	14,500	8,500

NOTES: Projections from the 1991 budget are noted as, for example, Debt Charges 91, while those from the 1992 budget are noted with the equivalent suffix.

SOURCE: Minister of Finance, *the Budget*, Ottawa, February 26, 1991, p. 94; and Minister of Finance, *the Budget*, Ottawa, February 25, 1992, p. 106.

The fiscal picture painted by this budget is not as pretty as last year's. The effects of the recession are clearly seen in the revenue projections. The 1992 budget projections to the year 1995-96 predict a shortfall of $39,000 million *vis-à-vis* the predictions made in last year's budget. And only $7,300 million of this shortfall can be attributed to measures announced in the 1992 budget. The recession's impact on revenues appears to be long-lived, according to this view, with the greatest impact to be in fiscal year 1993-94, a year in which economic growth is expected to be strong and well underway. This pattern is reminiscent of the 1981-82 recession in which the major fiscal difficulties did not show up until a couple of years later.

Despite the recession, however, the government is able to project cumulative program spending to 1995-96 at $10,000 million below last year's projections. The initiatives announced in this budget account for most of this decrease. The significant decline in inflation would account for part of the remainder.

It appears that the dramatic decline in inflation and the large drop in interest rates will give the federal government a bonus of about $12,000 million in lower debt-servicing costs over five years. Despite this, and despite the decline in program spending, the net public debt will grow by $17,000 million over five years in excess of the projections made last year. In 1993-94, the deficit will exceed last year's forecast by almost $6,000 million.

It is clear from this table and the measures presented in the budget that the federal government in 1992 has not chosen to try to spend its way out of this recession. It has chosen to exacerbate these economic effects on the deficit by reducing taxes to a greater extent than it has reduced expenditures. On balance the amount is small. The greatest net addition to the deficit will be in 1993-94, when discretionary revenue decreases will exceed spending cuts by almost $800 million.

If fiscal stimulus is defined a net discretionary increase in the deficit, then these measures are pro-cyclical; they do not counter economic trends but rather amplify them. The federal government is deliberately adding to aggregate demand in a year when real output is

projected to increase by 4.5%. For 1992, when there is expected to be only 2.7% growth, no such fiscal stimulus is provided. Nevertheless, the overall fiscal stimulus presented by this budget is relatively so small that such timing irregularities are not of great concern.